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EFC - Q4 2012 Ellington Financial LLC Earnings Conference Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen, thank you for standing by. Welcome to the Ellington Financial Fourth Quarter 2012 Financial Results Conference Call.

(Operator instructions)

I would now like to turn the conference over to your host, Sara Brown, company counsel, please go ahead.

Sara Brown - *Ellington Financial LLC - Company Counsel*

Before we start, I'd like to remind everyone that certain statements made during this conference call, including statements considering future strategies and (inaudible) and plans may constitute forward looking statements within the meaning of the safe harbor provisions of the private securities litigation reform act of 1995. Forward looking statements are not historical in nature and can be identified by words such as believe, expect, anticipates, estimates, projects, plans, should, or similar expressions or by reference to strategies, plans or incentives.

As described under time 1A of our annual report on Form 10K filed on March 14th, 2012, and under item 1A of our quarterly report on our Form 10Q filed on May 9th, 2012, forward looking statements are subject to a variety of risks and uncertainties that could cause the company's' actual results to differ from its beliefs, expectations, estimates and projections.

Consequently, you should not rely on these forward looking statements as predictions of future events. Statements made during this conference call are made as of the date of this call and the company undertakes no obligation to update or revise any forward looking statements, whether as a result of new information, future events or otherwise.

I have with me today on the call Larry Penn, Chief Executive Officer of Ellington Financial, Mark Tecotzky, our Co-Chief Investment Officer, and Lisa Mumford, our Chief Financial Officer.

Larry Penn - *Ellington Financial LLC - CEO*

Thanks, Sara. Once again, it's our pleasure to speak with our shareholders this morning as we release our fourth quarter and full year 2012 results. And as always, we appreciate your taking the time to participate on the call today. We will follow the same format as we have for the past several quarters, first, our CFO Lisa Mumford will run through our financial results, then our Co-CIO, Mark Tecotzky will discuss how the MBS market performed over the course of the quarter, how we positioned our portfolio and what our market outlook is going forward. Then, I'll close our prepared remarks and we'll take some questions.

In addition to our earnings release, yesterday evening we posted a fourth quarter earnings conference call presentation to our website www.ellingtonfinancial.com. You'll find it right on the for our shareholders page or alternatively on the presentations page of the website. Lisa and Mark's prepared remarks will track the presentation.

So, it would be helpful if you have this presentation in front of you and turn to page three to follow along. And while you're getting that in front of you, I'm going to turn it over to our CFO, Lisa Mumford.

Lisa Mumford - *Ellington Financial LLC - CFO*

Thank you, Larry, and good morning, everyone.

On page three of the presentation, we provide our P&L attribution table. There you can see for the quarter we earned $24.8 million for $1.19 per share, bringing our total full year P&L to 97.1 million or $5.31 per share. Our return on equity was 22.5%.

Our predominant non agency strategy which also includes CMBS and commercial mortgage loans provided the lion's share of our P&L, actually 91% of our growth P&L in the quarter, and 86% for the year. But our agency strategy also performed very well during the quarter and year, especially when you consider that it only utilizes a relatively small amount of our capital.

In our non agency strategy, our income was driven by interest income and net realized and unrealized gains, the weighted average book yield on the portfolio declined slightly to 9.7% from 10.2% but our average holdings quarter over quarter increased by approximately 60 million, resulting in an increase of interest income, but a decline in the first share contributions income.

Trading gains and net valuation gains combined at $1.28 per share to the quarter's results. In our agency strategy, our income came from interest in net realized gains [sensibly]. Our weighted average book deal was essentially flat quarter over quarter at 2.7% but our average agency holdings increased in size by about [69 notes], valuation declines reduced our recorded results. Within both our non agency and agency portfolios, we continued to sell securities where we felt there was limited remaining upside potential and rotated into those where we see greater value.

Our overall average cost of funds declined two basis points during the quarter to 0.99% as the composition of our average borrowing did not change much quarter over quarter. However, our leverage ratio increased to 1.79 to one, since weighted toward the end of the quarter, we increased our holdings of agency RMBS which we generally finance with recalls and decrease our recall on our non agency holdings.

For expenses, which includes other operating expenses and base management fees and excludes incentive fees and financing costs came in at 2.8% of average equity on an annualized basis and was in line with our expectations.

In terms of our investment portfolio, our non agency MBS portfolio was $577 million at the end of December, and our agency RMBS portfolio was $774 million. During the quarter, we fully deployed the remaining proceeds from our third quarter secondary offering.

Our diluted book value per share was $24.38 at the end of December, compared to $23.88 per share at the end of September, and $22.03 at the end of December 2011. Year over year, this represents an increase of 10.7%.

Finally, our quarterly dividends of $0.77 per share represents a 10% increase from the dividend we paid for the first three quarters of 2012 and represents an annualized yield of 12.7% based on our closing price yesterday of $25.68 adjusted for our fourth quarter and special dividends.

With that, I will now turn the presentation over to Mark.

Mark Tecotzky - *Ellington Financial LLC - Co-Chief Investment Officer*

Thanks, Lisa. Before I walk through the slides I want to give you some views on the past quarter. The confluence of strong fundamentals, strong technicals and additional capital allocated to non agencies led to a strong quarter. The result of QE3 was to push some mortgage investors out of the agency market into the non agency market. That same backdrop has largely carried into 2013. Technicals and fundamentals are good, but the question now is valuation.

The EFCs over five years old and has been through times of terrible fundamentals and technicals, but they wound up being great times to invest because the valuations are so compelling, first quarter of 2009 for example, I can't imagine worse fundamentals and technicals, but the valuation is reflecting the state of the world far worse than what it actually was.

Let's turn to the presentation. Page 10, you can see we grew our portfolio in the fourth quarter by 47 million, that allowed us to participate even more fully in the Q4 rally. One sector we shrunk was CMBS, the part of the CMBS capital structure that we owned was so significantly in price and are highly levered, so it made sense to take some gains and reduce risk.

On page 11, you can see our yields are down from the last quarter, we're still compelling versus other sectors of fixed income, especially given the likely impact of QE3 on risk assets. We thought prices were much more likely to go up than down in the quarter, and that was the thinking behind growing the non agency portfolio.

Page 12 hedges, so no big change. We said in the last earnings call we thought that we would keep our credit hedges light, given our belief that housing is in the early stages of a multiyear recovery.

So on to page 14, the agency portfolio. For agency MBS, the big story in the quarter was the Fed. QE3 drove agency valuations to crazy levels early in the quarter before they cheapened up. This had a direct impact on what we do.

For the coupons the Fed actively buys like 30 year 3s, you need to be very careful about buying specified pools on that coupon and you really don't want to be short CBA because the roles are far too expensive. So we have largely avoided coupons that are the primary focus of Fed activity.

Interest rate hedge is on page 15. The entire agency side of the market has gotten much trickier. Our view has generally been, don't get in the way of the Fed, so as I said, for the TBA coupon to stay at buying when we think they will buy for the foreseeable future, we have [low] to avoid it being short. It's a very technical market and you have to be very careful because the biggest buyer in this space is not motivated by profit, so it can sometimes be difficult to predict their behavior.

Turning now to the overall picture of the markets and where we see things going from here. While we had a good quarter and a very good January, which we made visible for our monthly book value estimate, we aren't looking backwards, our focus is on generating returns going forward.

That's the challenge and the opportunity for us and we always try to force ourselves to look objectively at the market today and not be prejudiced by what happened last month or last year. What drove returns last year was what was last year, our job is to figure out what will work in the year age had.

For example, a year ago we thought housing had a chance to outperform expectations, now a year later, expectations are vastly more optimistic. While we still believe housing is in the early stages of a multi recovery, today's expectations may well prove too optimistic. Throughout the five year life of ESP, first as a private company and now as a public, we have differentiated ourselves from hybrid REITs in a few important ways.

One, we've always been focused on trying to hedge out interest rate risks. Two, we've managed a company with low leverage, and three, we have active trading as a source of return generation.

The truth be told, not all these differentiators have made us money, hedging interest rates has cost us and a year like last year, more leverage would have driven even better returns on the non ABC side. But think about these three tenants against the backdrop of the current market. From early

December to now, tender yield has increased about 40 basis points and investors are nervous about interest rate risks. If rising rates are a headwind for others it shouldn't be an issue for us.

As yields on the non agency mortgage bonds have compressed relative to their funding costs, the tradeoff between additional return and additional risks argues against a lot of leverage right now, that could change if funding costs come down, as we think they should. And active trading and securities selection, dynamic and -- a dynamic and forward thinking research initiative is going to be more important than ever in driving incremental returns for stock holders now that much of the beta capturing in non agencies is behind us.

Going forward, we are looking to other strategies to diversify our sources of return generation in the mortgage market. Overtime we expect that mortgage origination will be less agency dominated servicing will be less bank controlled and credit risk currently held by the GSEs will be spread out among numerous private investors.

EFC with its deep understanding of the mortgage market and payment risks and credit risks is working to find new attractive risk adjusted opportunities for our share holders as the mortgage market evolves.

With that, I'd like to turn the call over to Larry.

Larry Penn - *Ellington Financial LLC - CEO*

Thanks, Mark. Our fourth quarter results represent a continuation of our financial performance through the first three quarters of 2012. Both of our strategies, our non agency MBS strategy, which includes CMBS and commercial mortgage loans and our agency MBS strategy did extremely well in 2012.

We didn't just ride the tide in the rising non agency MBS market, as we've discussed on previous calls, we've been actively rotating our non agency MBS portfolio by selling higher priced securities and using the proceeds to reinvest into lower priced services where we see greater value.

In 2012, our portfolio turnover rate was just a bit below 100% per year. Now that doesn't mean we sold almost every security in our portfolio that we started the year with, we turned some of our capital over more frequently and some less frequently. But what it does illustrate is the notion that active management is fundamental to how we operate.

Within our agency MBS strategy we have been very successful at identifying fixed rate pools with prepayment and protection characteristics, as evidenced by the very slow prepayment speeds of our portfolio, under 10% CPR during the fourth quarter.

However, we've also been successful at selling our prepayment protective pools at the right time, when it's time to rotate into different prepayment protective pools. In the fourth quarter, we decreased our agency RMBS holdings as prices and payoffs reached all time highs. But since then, as we've seen the relative value in the sector improve a bit, we've reloaded somewhat. Again, illustrating the benefits of our active management style.

And because our strategy is to generate trading gains as a significant component of our earnings, we have the luxury of being able to operate with much more conservative leverage ratios than do our peers. This is also in confluence with our desire to maintain adequate liquidity to withstand severe financial shock as we did so well in 2008.

As you know, Ellington Financial's goal is to both capture upside in good markets and control downside in rough markets. And now, in Ellington Financial's sixth year of operation, I'm proud to say that I feel we've accomplished that each and every year to date. As you look at Ellington Financials leverage and returns and compare them to those of the hybrid agency, non agency mortgage REIT that we're most often compared with, keep in mind that most of them didn't even exist in 2008.

Looking forward to the rest of the year, the rally in non agency MBS has, as everyone knows, reduced current available yields on these securities significantly as compared to one year ago. In light of this, we believe security selection and security rotation is even more important now, especially since we expect there to be continued spread compression on the safer, more senior securities. All the more so as they shorten in duration with the passage of time.

Additionally, we believe there remains significant opportunities for continued sector rotation generally within non agency RMBS, it's not surprising after such a big rally that we believe that some sectors have moved more than they should have relative to other sectors. We believe that the CMBS sector will also continue to provide attractive opportunities this year and if I had to guess, I would say that commercial real estate debt instruments, such as CMBS, will comprise a much larger percentage of our deployed capital in 2013 than they did in 2012.

We also will continue to opportunistically invest in other mortgage related, real estate related and asset backed securities where we think it appropriate and where we see value. For example, in the mortgage and real estate related space, we purchases our first non performing commercial mortgage whole loan at the end of the fourth quarter and in the asset backed space, we mentioned last quarter that we had purchased a few CDOs from the Maiden Lane portfolio and we've also started and are actively looking at the CLO space.

Finally, as the RMBS market continues to heal, and the revival -- or at least partial revival of the residential MBS securitization market no longer seems so far away, we are actively strategizing ways that Ellington Financial will be able to capitalize on the inevitable opportunity. Our flexible corporate structure will help us here as well. 2013 will no doubt be very different from 2012, but we are very excited about our ongoing prospects.

In agency RMBS, we think an increased level of volatility creates investing and trading opportunities for us, and this occurred again in the fourth quarter. While the Fed recently reiterated its intent to continue its asset purchase programs until the unemployment rate improves substantially, we think that the market with good reason, might be less certain about the program timeline. It'll be our job to navigate any choppiness in the market and take advantage of the opportunities that may arise as a result of it.

In the meantime, we continue to employee our strategy of identifying and trading prepayment protected pools and our strategy will remain a hedged one with TBAs playing a substantial role in our hedging activities and possibly our investment activities as well.

Finally, we were of course extremely pleased to announce a $0.75 per share special dividend for 2012, as well as a fourth quarter dividend of $0.70 per share. This works out to the company paying out 75% of its 2012 earnings and retaining the rest. We continue to be optimistic on both our near term and long term outlook. Our platform allows us to be nimble and to take advantage of market opportunities as they arrive.

We can dial back or increase our pitted hedges when and as we see fit and I believe we haven't been shy about doing so. We are not just buy and hold investors capturing a leverage net interest margin. We actively trade the portfolio and this has, and we believe it will continue to be a very significant source of earnings.

This concludes our prepared remarks. Before I open the call up for Q&A, I would just like to remind everyone that, as usual, we'll be happy to respond to questions to the extent they are directed to matters related either specifically to Ellington Financial or more generally to the mortgage and asset backed marketplace in which it operates. We will not be responding to questions on Ellington's private funds or other activity.

And for the Q&A, we're joined by Mike Vranos, Ellington Management Group's CEO and Ellington Financial's Co-CIO. Operator?

QUESTIONS AND ANSWERS

Operator

Thank you, sir. (Operator instructions). Our first question is form the line of Trevor Cranston with JMP Securities. Please go ahead.

Trevor Cranston - *JMP Securities - Analyst*

Hi, thanks. Given your comments about valuation, particularly in the non agency space and the increase in prices we've seen continuing since the end of the year, can you guys talk a little bit about how you're thinking about the hedge book on the credit portfolio today? And also, maybe talk a little bit about how you think about relative value between opportunities maybe in the whole loan or MRS space versus the MBS market? Thanks.

Unidentified Company Representative

Hi, Trevor.

Trevor Cranston - *JMP Securities - Analyst*

Hi.

Unidentified Company Representative

I would say in terms of hedges, we're constantly looking at what we think is the loss adjusted yield on hedging instruments like ABS relative to the losses field on the cash bonds we buy. If you look at the size of the hedge book over time, so at the course of the last year, we've brought the hedge down substantially as we became much more constrictive on housing. So we'll continue to view that. I mean right now, I think that we think that we don't see the benefit of a large increase in the hedge book right now.

I just think that on the cash side, you've seen yields come in but they sort of came in for a reason. I think for a long time the sector was too cheap and we think it'll continue to perform, we just don't think the rate of acceleration in prices is going to be the same as what you saw in 2012.

Now, as we start to look at other opportunities we'll evaluate them on the same metric, and we spent a lot of time with our hosing model, which gets down [zip] level. I think we have a very good understanding of what drives borrower default. So, we'll apply the same models and we'll just look at different sectors. Relative value, expect returns. But just bearing in mind that some of the other -- some of the other opportunities might bring with them a little bit greater franchise value than what we get with just trading and portfolio securities.

Trevor Cranston - *JMP Securities - Analyst*

Okay, those are helpful comments. Thanks and congratulations on a great year.

Unidentified Company Representative

Thanks.

Operator

Thank you. Our next question is from the line of James Winchester with QVP. Please go ahead.

James Winchester - *QVP - Analyst*

Yes, good morning. I have just a general question. I saw on your remarks, you mention one of the factors that's been driving valuation is obviously the increasing level of home purchasing activity and a decline in shadow inventory and I was wondering if you could just comment on first of all, generally speaking, how large or how you quantify that shadow inventory and secondly, how much granularity you feel you have with regard to that figure, that dynamic. And then, lastly is there -- just as a secondary question.

When you look at the level of home purchasing activity in the United States today, do you distinguish at all between how much of that activity is driven by basically financial investors as opposed to ultimately end homeowner and do you think that really matters?

Larry Penn - *Ellington Financial LLC - CEO*

I'll -- let me start and then I'll -- this is Larry, I'll pass it over to Mark. Keep in mind that there's a -- just with all the question of housing, obviously it's a very regional and Ellington Financial, the biggest component of its portfolio are securities that are fairly diversified in the parts of the country where they have exposure. So, they do differ from deal to deal and that definitely factors into our thinking.

But just keep in mind that this is -- you mentioned, for example, the financial firms moving into the buying single family homes. That, on an overall countrywide basis, and it's certainly the securities that we invest in, is a very, very limited factor. It's been quite important in certain concentrated regions of the country. But for the securities that we invest in, it's generally fairly limited, but we do look at it and it does factor into some extent obviously. (Inaudible).

Mike Vranos - *Ellington Financial LLC - Co-Chief Investment Officer, CEO - Ellington Management Group*

Yes, hey -- this is Mike Vranos, so I guess in terms of some numbers and granularity, I do agree with Larry that we're buying rather geographically diverse pools of -- I mean in the assets that back the bonds we have but rather geographically diverse in terms of the number and the area that the [woes] are in. But that said, when you're looking at any particular trust that has some percentage of delinquencies, the granularity does matter, right? So we are looking through in a sub MSA basis, especially at loans that are in the trust that are highly delinquency. We have a data base of about 38 million loans and we are very active in terms of updating what the shadow inventory is right now.

Offered across the country I believe are about $68 billion worth of properties for sale that are presumably distressed -- probably bad loans, loans going bad. There's another $3 million to $4 million in [chattal] inventory that we update on a regular basis. Investor activity from REO to rental, I know from person experience, being involved in that market too, is -- seems like a -- it seems like there's a lot going on and there's been probably $10 billion plus in capital raised, but compared to the numbers I just mentioned, I think it's still small, right?

So, 680,000 loans, $100,000 a property, $68 billion compared to what, maybe $10 billion floating around by institutional and quasi institutional investors and then of course all the mom and pop players that are buying and renting. I think they do provide a floor to the market in many, many areas and they're not to be discounted at all but we're talking about a lot of -- it's a lot of very large shadow inventory. So, 3 million to 4 million homes, very close to a $0.5 trillion dollars worth of property to come up in the next four or five years.

James Winchester - *QVP - Analyst*

Yeah, exactly. All right. All right, thank you, appreciate it.

Unidentified Company Representative

Thank you.

Operator

Thank you. Our next question is from the line of Stephen Laws of Deutsche Bank. Please, go ahead.

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Stephen Laws - *Deutsche Bank - Analyst*

Hi, good morning. Thanks for taking my question, congratulations on a great quarter and an excellent year. I apologize if you addressed this in a prepared remarks, I was a little bit late joining the call, but I noticed in the press release you talked about buying a non performing commercial mortgage whole loan.

Can you maybe expand a little bit on your commercial strategy and potentially how big of a piece that could be going forward? Or is it really something that's just going to be more one off opportunistic investments?

Unidentified Company Representative

Yeah, I mean I think it's hard to tell. It's something -- commercials in general is an important -- we think of it as an important part of our strategy at Ellington Financial, we have dialed that up and down, the markets been volatile. It's -- our returns certain on capital, where we've deployed capital in that space have been very high.

We've been very nimble, and as I said in my prepared remarks, if I had to guess, that'll be -- commercials will be a bigger component of our strategy in 2013 than they were in 2012, the new issue market is quite robust there and there's exactly the kind of volatility that we like.

In terms of that non performing loan, that's a business that we've done here at Ellington for a while and something that we like for Ellington Financial and it is very opportunistic, it's not something that you see offered by dealers, it's something that we actually source ourselves here at Ellington and it could be -- it's one of those things that could be a bigger point of our strategy going forward. So, now -- yes, sure go ahead, Mike --

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Mike Vranos - *Ellington Financial LLC - Co-Chief Investment Officer, CEO - Ellington Management Group*

Yes, so in terms of the size of the opportunity, we over the last few years, have privately purchased over $200 million of loan balance amount for investment amount of about 130 million in non performing, multi family notes and small balance notes. And we were, truth be told, over that period of time, somewhat capital constrained, so that gives you an idea of sort of like what the lower limits for opportunity have been for us over the last few years.

Stephen Laws - *Deutsche Bank - Analyst*

Is it more distressed sellers coming to you looking for liquidity, is it a situation where you're more optimistic on the recovery than maybe what the seller's asking, with whole loans being a little bit more difficult to value, I guess, can you maybe talk about the back -- the due diligence you guys are able to perform there that creates these opportunities for you?

Unidentified Company Representative

Yeah, I mean obviously we perform a lot of due diligence on each loan. The opportunities come mostly from banks, there are a few other type of sellers as well where there -- they have a lot of problems in their portfolio in terms of not performing commercial loan and they want to focus their work out efforts on bigger loans, frankly, and so often they'll sell their smaller loans and it's just a great opportunity for us.

It's sort of a -- it's an asset class which is not real estate, although it may become real estate pretty soon, it's a loan, but it's a non performing loan which sort o takes a lot of debt players out of the market. So, it's a market where there isn't a natural audience for it that's that deep and we're playing at a level -- not the trophy properties, if you will, where we can buy very attractive -- very attractive investments, these are fairly short term in nature.

Our experience so far has been less than one year average holding period to resolution of disposition. So, it's a -- we just look forward to it frankly as yet another arrow in our quiver.

Stephen Laws - *Deutsche Bank - Analyst*

Great, well again, congratulations on the excellent performance in 2012 and look forward to another good year. Thank you.

Unidentified Company Representative

Thank you.

Operator

Thank you. T here appear to be no additional questions at this time, I would now like to turn the floor back to Larry Penn for any closing remarks.

Larry Penn - *Ellington Financial LLC - CEO*

No, that'll do it. Thanks everyone, and we look forward to seeing you for our next quarter's release.

Operator

Ladies and gentlemen, this concludes today's Ellington Financial fourth quarter 2012 financial results conference call. You may now disconnect.